

CONTENTS

	Page
I. Introduction-----	1
II. Summary-----	3
III. Description of Bills-----	7
1. H.R. 6877 (Messrs. Fisher and Burleson of Texas): Deficiency dividends for regulated investment companies which are small business investment companies (identical bills: H.R. 10220 (Mr. LaFalce), H.R. 10676 (Messrs. LaFalce, Baldus, Bedell, Le Fante, and Nowak), H.R. 11379 (Messrs. LaFalce, Adabbo, and Steed), H.R. 11454 (Messrs. Fisher, Duncan of Tennessee, and Jones of Oklahoma); and H.R. 12473 (Messrs. LaFalce, Neal, McKinney, and Howard))-----	7
2. H.R. 6989 (Mr. Martin): Tax exemption for certain mutual deposit guaranty organizations-----	10
3. H.R. 7207 (Messrs. Frenzel, Steiger, Quie, Fraser, Goodling, and Vento): Exemption for organizations furnishing computer and fiscal management services-----	12
4. H.R. 9192 (Mr. Waggonner): Tax treatment of Banks for Cooperatives-----	14
5. H.R. 10653 (Mr. Cotter): Tax treatment of transferor railroads under the ConRail reorganization-----	17
6. H.R. 11741 (Messrs. Lederer, Burke of Massachusetts, Burleson of Texas, Crane, Duncan of Tennessee, Jenkins, Ketchum, Pickle, Waggonner, and Rostenkowski): Contributions in aid of construction of gas and electric utilities (identical bills: H.R. 9380 (Mr. Lederer); H.R. 11997 (Messrs. Lederer, Burke of Massachusetts, Burleson of Texas, Crane, Duncan of Tennessee, Jenkins, Ketchum, Pickle, Waggonner, Rostenkowski, Archer, Fisher, and Brodhead); and H.R. 12339 (Messrs. Lederer, Burke of Massachusetts, Burleson of Texas, Crane, Duncan of Tennessee, Jenkins, Ketchum, Pickle, Waggonner, Rostenkowski, Archer, Fisher, Brodhead, and Vander Jagt))--	19
7. H.R. 12200 (Mr. Holland): Election to treat qualified stock options as nonqualified options-----	22

	Page
8. H.R. 12352 (Mr. Rostenkowski): Source of income of railroad rolling stock-----	25
9. H.R. 12592 (Mr. Frenzel): Services provided by a private foundation as trustee-----	27
10. H.R. 12606 (Mr. Waggonner): Tax-deferred annuities for employees of Uniformed Services University of the Health Sciences-----	29
11. H.R. 12828 (Mr. Jenkins): Convention and trade show activities of certain tax-exempt organizations-----	31

I. INTRODUCTION

The bills described in this pamphlet are those on which the Subcommittee on Miscellaneous Revenue Measures of the Committee on Ways and Means has announced a two-day public hearing for Wednesday, June 14, and Thursday, June 15, 1978.

In connection with this hearing, the staff of the Joint Committee has prepared a description of the bills, similar to the descriptions the staff was directed to prepare in connection with the hearings on miscellaneous bills during 1977.¹

The pamphlet first briefly summarizes the bills in consecutive bill number order. This is followed by a more detailed description of each bill indicating in each case the present law treatment, the issue involved, an explanation of what the bill would do, the effective date of the provision, the revenue effect of the provision, any prior Congressional consideration of the bill, and the position of the Treasury Department or other relevant departments with respect to the bill.

¹ The descriptions which the staff was directed to prepare were to indicate whether any of the bills were retroactive and to name any particular taxpayer to which a bill might be directed if the staff had such information.

II. SUMMARY

1. H.R. 6877—Messrs. Fisher and Burleson of Texas

Deficiency Dividends for Regulated Investment Companies which are Small Business Investment Companies

Under present law, a mutual fund qualifying for conduit treatment must distribute 90 percent of its taxable income within its taxable year or, with certain limitations, within the 12-month period after the taxable year. No deficiency dividend procedure is provided with respect to distributions made after this period. The bill would provide a deficiency dividend procedure for mutual funds that are also small business investment companies.

2. H.R. 6989—Mr. Martin

Tax Exemption for Certain Mutual Deposit Guaranty Organizations

Present law provides an exemption from Federal income taxation for State-chartered, nonprofit mutual corporations or associations organized before September 1, 1957, which provide reserve funds for, and insurance of shares or deposits in, State-chartered (1) domestic building and loan associations (savings and loan associations), (2) certain cooperative banks, or (3) mutual savings banks. The bill would extend the exemption to such organizations created before January 1, 1969, and also to organizations which provide reserve funds for, and insurance of, shares or deposits in credit unions and savings and loan associations.

3. H.R. 7207—Messrs. Frenzel, Steiger, Quie, Fraser, Goodling, and Vento

Exemption for Organizations Furnishing Computer and Fiscal Management Services

Under present law, a joint or cooperative venture formed by two or more charitable organizations to provide services to those organizations generally will not be recognized as exempt from Federal income tax unless the venture's services are provided at a charge substantially below cost. The Congress has provided statutory exceptions to this general rule for cooperative organizations which furnish certain services to tax-exempt hospitals or which furnish collective investment services to tax-exempt educational organizations. The bill would create an additional exception for an organization owned and operated by certain "qualified social service organizations" which are

exempt under section 501(c)(3) of the Code, if the cooperative organization provides computer data processing or fiscal management services at cost exclusively to two or more "qualified social service organizations."

4. H.R. 9192—Mr. Waggonner

Tax Treatment of Banks for Cooperatives

Under present law, the sale or exchange of a bond or other evidence of indebtedness by certain financial institutions is not treated as a sale or exchange of a capital asset. Gains and losses from these transactions are considered ordinary gains and losses for these financial institutions. In addition, gain or loss from a foreclosure is not recognized by certain financial institutions until ultimate disposition of the property acquired by foreclosure. The bill would extend both these provisions to the Banks for Cooperatives.

5. H.R. 10653—Mr. Cotter

Tax Treatment of Transferor Railroads Under the ConRail Reorganization

The bill would provide that expired net operating losses could be used against income realized by one member of an affiliated group of corporations from certificates of value issued as a result of the ConRail reorganization to another member of the group.

6. H.R. 11741—Messrs. Lederer, Burke of Massachusetts, Burleson of Texas, Crane, Duncan of Tennessee, Jenkins, Ketchum, Pickle, Waggonner, and Rostenkowski

Contributions in Aid of Construction to Gas and Electric Utilities

The bill would treat certain contributions to regulated public gas and electric utilities in aid of construction as contributions to capital by nonshareholders and not as taxable income to the utility.

7. H.R. 12200—Mr. Holland

Election to Treat Qualified Stock Options as Nonqualified Options

The Tax Reform Act of 1976 made several changes to the minimum tax and maximum tax provisions, effective for taxable years beginning after December 31, 1975, which have resulted in less favorable treatment to individual taxpayers than under prior law on exercise of a "qualified stock option." As a result, taxpayers exercising qualified stock options in taxable years beginning after 1975 may be subject to a greater tax than taxpayers exercising generally similar but nonqualified options. The bill allows an individual taxpayer to file an election to treat an otherwise qualified stock option as a nonqualified option.

8. H.R. 12352—Mr. Rostenkowski**Source of Income of Railroad Rolling Stock**

The bill would treat income or loss from the rental of railroad rolling stock to a U.S. railroad as U.S. source income or loss if the rolling stock is leased for use within the United States and any expected use of the rolling stock in Canada or Mexico is on a temporary basis not to exceed 90 days in a taxable year.

9. H.R. 12592—Mr. Frenzel**Services Provided by a Private Foundation as Trustee**

The bill would permit a private foundation to furnish services to a disqualified person without regard to the self-dealing provisions if the services are performed as trustee of an irrevocable trust in which the foundation has a beneficial interest, the foundation is reasonably compensated for the services, and the disqualified person's status results from the operation of a trust which was irrevocable prior to October 9, 1969.

10. H.R. 12606—Mr. Waggonner**Tax-Deferred Annuities for Employees of Uniformed Services University of the Health Sciences**

Present law provides that if an annuity is purchased for an employee by an exempt organization described in section 501(c)(3) of the Code or by a public school system, then the employer's contributions for the annuity contract are excludable, within certain limitations, from the employee's gross income and not subject to tax until the employee receives payments under the annuity contract. The bill would extend the same rule to qualifying annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences, which was established by the Congress under the Department of Defense to train medical students for the uniformed services.

11. H.R. 12828—Mr. Jenkins**Convention and Trade Show Activities of Certain Tax-Exempt Organizations**

Under present law, income derived by tax-exempt labor or trade association organizations from a convention and trade show activity is not subject to the unrelated business income tax if the activity is intended to stimulate interest in and demand for the products of the industry in which the organization's members are engaged. The bill would extend the exemption (1) to income from convention and trade show activities intended to educate persons in the industry in the development of new products and services or new rules and regulations affecting the industry (so-called "supplier shows"), and (2) to income from convention and trade show activities (including "supplier shows") conducted by charitable, educational, religious, and similar organizations exempt from tax under section 501(c)(3) of the Code.

III. DESCRIPTION OF BILLS

1. H.R. 6877—Messrs. Fisher and Burleson of Texas

Deficiency Dividends for Regulated Investment Companies Which Are Small Business Investment Companies

Present law

Under present law, a regulated investment company (commonly called a mutual fund) is generally treated as a conduit for income tax purposes. The taxable income of the company which is distributed to the investors each year is taxed to them without being subjected to a tax at the company's level. The company is subject to the corporate income tax on the income it retains. This treatment is accomplished by allowing a deduction to the company for its distributions to the investors.

A small business investment company is a company formed under the Small Business Investment Act of 1958 to furnish equity capital and long-term credit for small business concerns. These investment companies may qualify to be treated as regulated investment companies.

In order to qualify for conduit treatment, a company, including a small business investment company, must satisfy a number of requirements. Generally, the company must be a domestic corporation which is registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust. In addition, a company must satisfy requirements relating to the portion of gross income which must consist of investment-type income, the portion of assets which must be represented by cash and securities, the portion of its income which must be distributed to the investors, and its stock ownership.

With respect to distributions, the company must distribute at least 90 percent of its taxable income, determined with certain modifications and without regard to the deduction for dividends paid, within its taxable year or, with certain limitations, within the 12-month period after the taxable year (secs. 852(a) and 855). Unlike the treatment of real estate investment trusts, no deficiency dividend procedure is provided for a regulated investment company so that, under certain conditions, dividends paid after the taxable year and the following 12-month period may be taken into account for purposes of the 90-percent distribution requirement. Thus, a subsequent audit change by the Internal Revenue Service which increases income may cause the company to fail to meet the distribution requirement.

Issue

The issue is whether a regulated investment company which is also a small business investment company should be permitted to pay qualifying dividends after the expiration of the regular period for the payment of qualifying dividends.

Explanation of the bill

The bill would provide a deficiency dividend procedure for regulated investment companies that are also small business investment companies. The procedure would be available only for a small business investment company which is licensed under the Small Business Investment Act of 1958 and which qualifies and elects to be taxed as a regulated investment company.¹

Under the procedure, the company could make qualifying distributions after the regular period for making distributions when an adjustment by the Internal Revenue Service occurs that either increases the amount which the corporation is required to distribute to meet the distribution requirement or decreases the amount of the dividends previously distributed for that year. This deficiency dividend procedure would be available only where the entire amount of the adjustment is not due to fraud with intent to evade tax or willful failure to file an income tax return.

Interest at the regular rate would be imposed on the amount of the deficiency dividend. In addition, a penalty equal to the interest charge would be imposed but the penalty could not exceed 50 percent of the deficiency dividend. The imposition of a penalty and interest is designed to discourage a company from reducing its current distributions of income in reliance on the availability of the deficiency dividend procedure to retain its qualified status.

The procedure is similar to the deficiency dividend procedure provided for real estate investment trusts by the Tax Reform Act of 1976.

The bill would benefit the Allied Investment Company of Washington, D.C. In addition, there are approximately 28 small business investment companies which have elected, or may elect, to be taxed as regulated investment companies and which might benefit from the bill.

Identical bills

The following bills are identical to H.R. 6877: H.R. 10220 (Mr. LaFalce); H.R. 10676 (Messrs. LaFalce, Baldus, Bedell, Le Fante, and Nowak); H.R. 11379 (Messrs. LaFalce, Addabbo, and Steed); H.R. 11454 (Messrs. Fisher, Duncan of Tenn., and Jones of Oklahoma); and H.R. 12473 (Messrs. LaFalce, Neal, McKinney, and Howard).

Effective date

The bill would be effective for determinations occurring after the date of enactment.

Revenue effect

It is estimated that enactment of this bill would reduce budget receipts by about \$200,000 in fiscal year 1979 and by less than \$500,000 annually thereafter.

¹ The Federal Tax Division of the American Institute of Certified Public Accountants has recommended the adoption of a deficiency dividend procedure similar to that provided for real estate investment trusts for all regulated investment companies rather than just those companies which are also small business investment companies. Federal Tax Division of the American Institute of Certified Public Accountants, *Recommended Tax Law Changes* 69 (1977).

Departmental position

The Treasury Department supports the bill and supports extension of the deficiency dividend procedure to all regulated investment companies. However, the Treasury believes that the bill in its present form should be amended in certain technical respects. In particular, the procedure should be conformed to that provided for real estate investment trusts by the Tax Reform Act of 1976. (See secs. 1601(b)-(f) of P.L. 94-455.)

2. H.R. 6989—Mr. Martin

Tax Exemption for Certain Mutual Deposit Guaranty Organizations

Present law

Present law provides an exemption from Federal income taxation for State-chartered, nonprofit mutual corporations or associations organized before September 1, 1957, which provide reserve funds for, and insurance of shares or deposits in, State-chartered (1) domestic building and loan associations ("savings and loan associations"), (2) certain cooperative banks, or (3) mutual savings banks (sec. 501(c)(14)(B)).

Issues

One issue is whether the present exemption for certain mutual deposit guaranty organizations should be extended to organizations created after September 1, 1957, and, if so, whether the extension of the exemption should be made retroactively.

Another issue is whether the present exemption should be extended to include organizations which provide reserve funds for, and insurance of shares or deposits in, both credit unions and savings and loan associations.

Explanation of the bill

One provision of the bill would retroactively extend Federal income tax exemption to any State-chartered organization created before January 1, 1969, which provides reserve funds for, and insurance of shares or deposits in, State-chartered savings and loan associations, cooperative banks, or mutual savings banks. This provision apparently would benefit only the Maryland Savings-Share Insurance Corporation and would exempt that organization from tax effective for all taxable years beginning after December 31, 1967.

Another part of the bill would prospectively provide Federal income tax exemption for certain State-chartered organizations created before January 1, 1969, which provide reserve funds for, and insurance of shares or deposits in, both State-chartered credit unions and State-chartered savings and loan associations. This provision apparently would benefit the North Carolina Savings Guaranty Corporation, and would exempt that organization for taxable years ending after the date the bill is enacted.¹

¹ Two other bills, H.R. 943 (Mr. Kastenmeier) and H.R. 1153 (Mr. Pickle), would exempt from taxation State-chartered mutual nonprofit organizations which provide reserve funds for, or insurance of shares and deposits in, State-chartered credit unions. The tax exemption provided by these bills would apply to taxable years ending after the date of enactment. These bills would provide tax-exempt status for the following 14 organizations:

Connecticut Credit Union Share Insurance Corp.
Florida Credit Union Guaranty Corp.
Kansas Credit Union Guaranty Corp.

Effective date

The provision in the bill extending exemption to a mutual deposit guaranty organization which is created before January 1, 1969 and which provides reserves and share insurance for savings and loan associations would apply to all taxable years beginning after December 31, 1967. The provision of the bill extending exemption to an organization providing reserves and share insurance for both credit unions and savings and loan associations would apply to taxable years ending after the date of enactment.

Revenue effect

The bill is estimated to result in a decrease in budget receipts of approximately \$5 million in fiscal year 1979 and less than \$1 million per year thereafter.

Prior Congressional action

In 1976, a similar provision was adopted on the Senate floor during consideration of the 1976 tax reform bill (H.R. 10612). This provision would have extended the present exemption to organizations created before January 1, 1969 which provide reserve funds for, and insurance of shares or deposits in, savings and loan associations, credit unions, cooperative banks, or mutual savings banks. This floor amendment, which would have benefited the two organizations mentioned above (and also, apparently, one other organization), would have been effective December 31, 1975, but it was deleted in conference.

Departmental position

The Treasury Department opposes the bill and supports repeal of section 501(c)(14)(B). The Treasury notes that organizations described in section 501(c)(14)(B) were first granted tax exemption because they served tax-exempt financial institutions. The institutions they serve are now taxable. Therefore, the Treasury believes tax-exempt status of these organizations should be ended.

Maryland Credit Union Insurance Corp.
 Massachusetts Credit Union Share Insurance Corp.
 New Mexico Credit Union Share Insurance Corp.
 Ohio Credit Union Shareowners Guaranty Corp.
 Rhode Island Share and Deposit Insurance Corp.
 Tennessee Share Insurance Corp.
 Texas Share Guaranty Credit Union
 Utah Share and Deposit Guaranty Corp.
 Virginia Credit Union Share Insurance Corp.
 Washington Credit Union Share Guaranty Association.
 Wisconsin Credit Union Savings Insurance Corp.

(These bills, however, would not appear to cover the Georgia Credit Union Deposit Insurance Corporation or the North Carolina Savings Guaranty Corporation because these two organizations also provide reserves or share insurance for savings and loan associations.)

These bills are substantially identical to two bills on which hearings were held by the Ways and Means Committee (on August 26, 1976) in the 94th Congress (H.R. 13532 (Mr. Pickle) and H.R. 14857 (Mrs. Keys)). No further action was taken on these bills in the 94th Congress.

3. H.R. 7207—Messrs. Frenzel, Steiger, Quie, Fraser, Goodling, and Vento

Exemption for Organizations Furnishing Computer and Fiscal Management Services

Present law

Under present law, a joint or cooperative venture formed by two or more charitable organizations to provide services to those organizations generally will not be recognized as exempt from Federal income tax unless the venture's services are provided at a charge substantially below cost.¹

The Congress has provided two limited statutory exceptions to this general rule. Section 501(e) of the Code, enacted in P.L. 90-364, treats a cooperative hospital organization as a section 501(c)(3) public charity if the organization performs, on behalf of two or more tax-exempt hospitals, any of certain specified types of services, provided that the performance of such services would be considered an exempt-purpose function if carried out directly by a hospital. These services include data processing, purchasing, warehousing, billing and collecting, food, industrial engineering, laboratory, printing, communications, records center, and personnel services. The 1976 Tax Reform Act (P.L. 94-455) extended the list to include "clinical" services. Section 501(f) of the Code, enacted in P.L. 93-310, extended section 501(c)(3) status to cooperative organizations formed by tax-exempt colleges, universities, etc., to provide collective investment services.

Section 501(e) requires that exempt hospital service organizations be operated cooperatively and remit all net earnings annually to their patrons on the basis of services performed for each. Section 501(f) requires that exempt collective investment funds remit all net income to their patrons.

Issue

The issue is whether an organization which is formed and controlled by two or more "social service" charities affiliated with a religious organization (or by two or more organizations which are constituent parts of a tax-exempt religious organization and which, if separately operated, would qualify as such religious-affiliated "social service" charities), and which furnishes computer and fiscal management services at cost to such organizations, qualifies for exemption from Federal income taxation and eligibility to receive tax-deductible contributions.

¹ See Rev. Rul. 71-529, 1971-2 C.B. 234; Rev. Rul. 72-369, 1972-2 C.B. 245.

Explanation of the bill

The bill provides that an organization owned and operated by two or more "qualified social service organizations" will be treated as organized and operated exclusively for charitable purposes if it provides, at cost, computer data processing or fiscal management services exclusively to two or more qualified social service organizations. For this purpose, the bill defines "cost" as amounts that do not "significantly exceed the actual cost (including straight-line depreciation) of performing such services."

Under the bill, a "qualified social service organization" is an organization which (1) is exempt from taxation under section 501(c)(3) as an organization whose primary purpose is to provide social services to the public and (2) is affiliated with a religious organization which also is tax-exempt under section 501(c)(3). In addition, a constituent part of a religious organization could be a qualified social service organization if, had it been organized and operated as a separate entity, it would qualify for tax exemption as an organization whose primary purpose is to provide social services to the public.

The primary intended beneficiary of the bill is Service Information Systems, Inc., of Minneapolis, Minnesota.

Effective date

The bill would apply to taxable years beginning after the date of enactment.

Revenue effect

The bill is estimated to result in a decrease in fiscal year budget receipts of less than \$1 million per year.

Departmental position

The Treasury Department opposes this bill. Unlike hospital service organizations described in section 501(e) or educational collective investment funds described in section 501(f), the service organizations that would be exempted by this bill need not be cooperative. As a corollary, such organizations, again in contrast with organizations described in section 501(e) or section 501(f), would be exempt even though services were provided to customers for charges that did not "significantly exceed the actual cost (including straight line depreciation) of performing such services." (Emphasis added) Thus, the bill would permit the organization to derive a profit from the provision of services.

If these defects were remedied, the organizations sought to be exempted by this legislation could operate as exempt member cooperatives under subchapter T (sections 1381 *et seq.*) of the Code. The only remaining advantage to being exempt under section 501 would be that, in some States, it might simplify obtaining a State tax exemption. Securing a State tax exemption is not an appropriate reason for an otherwise unnecessary exemption for Federal income tax purposes.

4. H.R. 9192—Mr. Waggoner

Tax Treatment of Banks for Cooperatives

Present law

Banks for Cooperatives

The Banks for Cooperatives, one of which is located in each of the twelve Farm Credit districts, and a Central Bank for Cooperatives in Denver, Colorado, were organized under the Farm Credit Act of 1933.¹ The Banks extend credit to certain cooperatives. The Central Bank for Cooperatives services district Banks for Cooperatives by making direct loans to them and participating in loans that exceed their respective lending limits (12 CFR 600.60). Only qualified cooperatives (generally those which are owned by farmers, ranchers, or producers of aquatic products) may borrow from the Banks.²

The Banks presently obtain the major portion of their loan funds through the sale of short-term bonds secured by notes of borrowers. The Banks do not accept deposits as do commercial banks. The annual net earnings of the Banks are distributed to borrowers as patronage refunds in the form of cash and additional equity capital. A Bank for Cooperatives may issue classes of stock other than voting shares, but dividends on this stock may not exceed 8 percent per year.

Under present tax law, Banks for Cooperatives are taxed under subchapter T of the Code (secs. 1381 through 1388) as nonexempt cooperatives. Generally, nonexempt cooperatives do not pay tax on income earned in transactions with or for patrons (called patronage income) if they distribute the income to their members within 8½ months after the close of the taxable year. Members must account for the income distributed to them in preparing their income tax returns. Distributions generally may be made in money, qualified written notices of allocation, or other property.

Although the Banks carry on some of the normal functions of banking institutions, they are not generally treated as banking institutions under the tax law. They do not qualify as banks under the tax laws under the tax law. They do not qualify as commercial banks under the tax law principally because they do not accept deposits. Also, they do not qualify as cooperative banks under the tax law

¹ The Banks for Cooperatives were initially organized and capitalized by the Federal Government pursuant to the Farm Credit Act of 1933. The Banks are considered an integral part of the cooperative Farm Credit System, which also includes the Federal Land Banks and the Federal Intermediate Credit Banks. The Banks of the Farm Credit System remained largely owned by the Government until the Farm Credit Act of 1953. This Act provided for the ultimate retirement of all Government capital in the System by December 31, 1968. The Farm Credit Act of 1971 recodified all prior laws governing the Farm Credit System and is now the Act governing the complete cooperative Farm Credit System.

² The Banks provide approximately two-thirds of the credit used by agricultural cooperatives. Bank for Cooperatives, Circular 40 (April 1973).

because their loans are not secured principally by residential real property. However, Banks for Cooperatives are allowed the longer net operating loss carryback and carryover periods (10-year carryback and 5-year carryover) allowed banking institutions. These Banks are not presently eligible for the special tax rules described below which apply to certain financial institutions with respect to sales or exchanges of securities and loan foreclosures.

Character of gain or loss from sales of securities by a financial institution

Under present law (Code sec. 582(c)(1)), the sale or exchange of a bond, debenture, note, certificate, or other evidence of indebtedness by certain financial institutions (including banks, trust companies, mutual savings banks, small business investment companies, and domestic building and loan associations) is not considered a sale or exchange of a capital asset. Therefore, financial institutions treat net gains from these transactions as ordinary income and net losses as ordinary losses.

Generally, the sale or exchange of a bond, debenture, note, certificate, or other evidence of indebtedness by a Bank for Cooperatives must be treated as a sale or exchange of a capital asset. These gains and losses are treated as nonpatronage income and are not taken into account in computing the deductible patronage dividend. Thus, these gains and losses are taken into account by a Bank for Cooperatives in computing its taxable income.³ However, as in the case of other corporations, capital losses are deductible only against capital gains (Code sec. 1211(a)) and cannot be used to offset nonpatronage ordinary income, such as interest income from investments in Government securities or surplus funds loaned to other farm credit banks.⁴

Treatment of foreclosures

Under present law (Code sec. 595(a)), foreclosures by certain financial institutions (such as mutual savings banks and domestic building and loan associations) are not taxable events (i.e., no gain or loss is recognized). Amounts received by these financial institutions from the disposition of the foreclosed property are treated as payments on the indebtedness. Thus, certain financial institutions are able to account for gain or loss resulting from a loan foreclosure at the time the foreclosed property is sold rather than at the time of foreclosure.⁵ Postponement of recognition eliminates the need to value the property. Losses are treated as bad debts.

Other lenders, including the Banks for Cooperatives, and certain banks (other than mutual savings banks, domestic building and loan associations, and cooperative banks) are not eligible for this non-recognition treatment with respect to foreclosures. Instead, they are required to determine, at the time of the foreclosure, the fair market value of foreclosed property, close the loan account, and calculate gain or loss. The basis of foreclosed property in the hands of a Bank

³ Treas. Reg. § 1.1382-3(c)(2), and Rev. Rul. 73-497, 1973-2 CB 314.

⁴ It is understood that most of the Government securities now held by Banks for Cooperatives are selling at substantial discounts because of their low interest rates. Because the Banks for Cooperatives have the limited function of providing financing to eligible farmers' cooperatives, they rarely have capital gains against which to offset the capital losses.

⁵ The tax law also provides special rules that limit the gain or loss recognizable by a seller upon his reacquisition of real property in satisfaction of the purchase debt (Code sec. 1038).

for Cooperatives is equal to the fair market value of the property at the time of the foreclosure. Upon the subsequent sale or other disposition of the foreclosed property, gain or loss for post-foreclosure appreciation or depreciation is recognized by the Bank for Cooperatives and is treated as nonpatronage income.

Issues

One issue is whether gain or loss from the sale or exchange of a bond, debenture, note, certificate, or other evidence of indebtedness by a Bank for Cooperatives should be treated as ordinary income or loss rather than as capital gain or loss.

Another issue is whether gain or loss resulting from the acquisition of property from a foreclosure by a Bank for Cooperatives should be recognized at the time of the sale of the foreclosed property rather than at the time of foreclosure.

Explanation of the bill

The bill provides that the sale or exchange of a bond, debenture, note, certificate, or other evidence of indebtedness by a Bank for Cooperatives will be treated as a sale or exchange of property that is not a capital asset. Thus, the sales of these assets by a Bank for Cooperatives would produce ordinary, rather than capital, gain or loss.

In addition, the bill provides that no gain or loss will be recognized at the time of foreclosure of property by a Bank for Cooperatives. Amounts realized with respect to the foreclosed property subsequent to foreclosure would be treated as payments of the indebtedness and any resulting loss would be treated as a bad debt while any gain realized would be treated as ordinary income.

Effective date

The amendments made by the bill would apply to Banks for Cooperatives for taxable years ending after the date of enactment.

Revenue effect

It is estimated that enactment of the provision which provides that gains and losses from sales or exchanges of securities are to be treated as ordinary income would result in a total revenue loss of about \$2 million. It is further estimated that enactment of the provision which permits deferral of any gain or loss from a foreclosure until final disposition of the property acquired, would reduce annual budget receipts by a negligible amount.

The bill is estimated to reduce budget receipts by a negligible amount in fiscal year 1978 and by a total of \$2 million during the next five fiscal years.

Departmental position

The Treasury Department does not oppose the portion of the bill that provides for ordinary gain or loss treatment on the sale or exchange of a bond or other evidence of indebtedness. However, the Treasury Department does oppose the portion of the bill that provides for nonrecognition at the time of foreclosure of property.

5. H.R. 10653—Mr. Cotter

Tax Treatment of Transferor Railroads Under the ConRail Reorganization

Present law

On April 1, 1976, eleven insolvent midwestern and northeastern railroads, along with many of their subsidiaries and affiliates, transferred their railroad properties to the Consolidated Rail Corporation (ConRail). These transfers were mandated and approved by the Congress¹ in order to provide financially self-sustaining rail services in areas served by these bankrupt railroads.

Under this legislation, ConRail, a taxable corporation, was to acquire, rehabilitate, and operate the railroad properties. The transferor railroads (and their subsidiaries and affiliates) will receive ConRail stock and "certificates of value" issued by the United States Railway Association, a nonprofit Government corporation formed to oversee the Conrail reorganization. A special court will eventually determine the value of these certificates in order to set the amount of compensation the transferor railroads will receive for their properties.

In 1976, the Congress also enacted legislation to deal with the tax consequences of this reorganization to ConRail, the transferor railroads, and the shareholders and creditors of the transferor railroads. This legislation² includes a provision that allows a transferor railroad's net operating losses eligible for carryover (at the time of the transfer of property to ConRail) to be extended beyond the normal expiration date,³ but only for use by the transferor against any future income arising from awards of the courts and the redemption of certificates of value.

Literally, the language of the ConRail tax amendments (sec. 374(e)(1)(A)) requires that net operating loss carryovers which are extended may not be applied to income arising from the certificates of value received by any corporation other than the corporation which originally received these certificates.⁴

¹ The facilitating legislation for the transfers was the Regional Rail Reorganization Act of 1973 (P.L. 93-236, approved January 2, 1974) and the Railroad Revitalization and Regulatory Reform Act of 1976 (P.L. 94-210, approved February 5, 1976).

² P.L. 94-253, approved March 31, 1976.

³ Under present law, the transferor railroads are generally entitled to 5-year carryover periods for these losses.

⁴ In at least one case, an affiliated group of transferor corporations filed consolidated income tax returns for a number of years preceding the April 1, 1976, ConRail transfer and have sizable consolidated net operating loss carryovers which are eligible for the special extended carryover period. Many of the subsidiaries in this group transferred all of their railroad assets to ConRail and presently hold as their only assets the certificates of value or the right to receive these certificates. The parent corporation would like to simplify the corporate structure by merging or liquidating many of its now nonoperating subsidiaries into other members of the group. However, the language of the existing Code provision would appear to prevent the use of the extended net operating loss carryovers against income from the certificates of value because the surviving corporation which receives the certificates of value in a merger or liquidation would not be the original recipient of the certificates.

Issue

The issue is whether the extended net operating loss carryover rules should apply to income realized from the certificates of value by a member of an affiliated group of corporations other than the member of the group which originally received the certificates.

Explanation of the bill

The bill would amend Code section 374(e)(1)(A)(iv) to allow the use of expired net operating loss carryovers against income which is realized from ConRail certificates of value by a member of an affiliated group of corporations where the certificates were originally issued to another corporation which was, on the date of issuance, a member of the same affiliated group.

The bill would benefit the Penn Central Transportation Corporation and may benefit the other ten railroad corporations which were parties to the ConRail reorganization.

Effective date

The bill would apply to taxable years ending after March 31, 1976.

Revenue effect

Enactment of this bill is not expected to have a significant effect on budget receipts.

Departmental position

The Treasury Department does not oppose the bill.

6. H.R. 11741—Messrs. Lederer, Burke of Massachusetts, Burleson of Texas, Crane, Duncan of Tennessee, Jenkins, Ketchum, Pickle, Waggoner, and Rostenkowski

Contributions in Aid of Construction of Gas and Electric Utilities

Present law

In general

Generally, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation (sec. 118). Nonshareholder contributions of property to the capital of a corporation have a zero basis to the corporation. If money is contributed by a nonshareholder, the basis of any property acquired with the money during the 12-month period beginning on the date the contribution is received, or of certain other property, is reduced by the amount of the contribution (sec. 362(c)).

Tax treatment prior to the Tax Reform Act of 1976

Early in the development of the Federal income tax laws, there were a number of court decisions which held that customer contributions to public utilities to pay for the costs of extension service lines were to be treated as contributions to capital, and not as income, of the public utility.

In 1958, the Internal Revenue Service announced that it would apply that early case law with respect to contributions to regulated utilities in aid of construction (Rev. Rul. 58-535, 1958-2 C.B. 25). In 1975, the Internal Revenue Service issued Rev. Rul. 75-557 (1975-2 C.B. 33) which revoked the 1958 ruling, withdrew the acquiescences in the early line of cases, and held that amounts paid by the purchaser of a home in a new subdivision as a connection fee to obtain water service were includible in the utility's income. The ruling was made prospective for transactions entered into on or after February 1, 1976.

Tax Reform Act of 1976

Generally, the Tax Reform Act of 1976 provided that contributions in aid of construction to regulated public water and sewerage utilities (but not other utilities) are to be treated as nontaxable contributions to capital. However, nontaxable treatment was not provided for customer connection fees. Customer connection fees include payments made by a customer to the utility for the cost of installing the connection between the customer's property and the utility's main water or sewer lines (including the costs of meters and piping) and any amounts paid as service charges for stopping or starting service. In addition, the Act provided that a water or sewerage utility which received a nontaxable contribution in aid of construction was to receive no depreciation deductions or investment credit on property acquisitions attributable to the contribution.

The Act did not affect the treatment of contributions to utilities other than water and sewerage utilities.

Issue

The issue is whether contributions in aid of construction to regulated public gas and electric utilities should be treated as contributions to the capital of those utilities by nonshareholders or as taxable income to the utilities.

Explanation of the bill

The bill provides that contributions in aid of construction, received by gas and electric utilities, would be treated as contributions to capital by nonshareholders and not as taxable income to the utility. The bill would extend to these utilities the provisions applicable to water and sewerage utilities. Accordingly, similar taxable treatment would apply to customer connection fees. Also depreciation and investment tax credits would not be allowable for property acquired with the non-taxable contributions.

Identical bills

The following bills are identical to H.R. 11741: H.R. 9380 (Mr. Lederer); H.R. 11997 (Messrs. Lederer, Burke of Mass., Burleson of Texas, Crane, Duncan of Tenn., Jenkins, Ketchum, Pickle, Waggonner, Rostenkowski, Archer, Fisher, and Brodhead); and H.R. 12339 (Messrs. Lederer, Burke of Mass., Burleson of Texas, Crane, Duncan of Tenn., Jenkins, Ketchum, Pickle, Waggonner, Rostenkowski, Archer, Fisher, Brodhead, and Vander Jagt).

Effective date

The bill would apply to contributions made after January 31, 1976.

Revenue effect

If all the contributions in aid of construction were treated as income, the annual increase in tax liabilities is estimated to be in the range of \$130-\$200 million. This estimate takes into account the increases in the amounts the utilities would charge to their customers if all the contributions were treated as income to the utilities. It is uncertain when these tax liabilities would first be reflected in higher budget receipts, however. If the electric and gas utilities rely on past treatment and file tax returns as if Revenue Ruling 75-557 applied only to water and sewage companies, higher assessments of taxes against the electric and gas utilities probably would not occur until their 1976 tax returns are audited, probably some time during calendar year 1979. Some of these assessments undoubtedly would be contested in court, but some might not. Thus, the first major impact on the budget receipts would very likely be in fiscal year 1980, but the timing of the higher tax payments and the amounts cannot be estimated by fiscal year with any degree of accuracy.

On the other hand, if Revenue Ruling 75-557 were limited to water and sewage utilities and does not apply to gas and electric utilities, and if court decisions would be in favor of the utilities, then the proposal to broaden section 2120 of Public Law 94-455 would have no revenue effect because it could be viewed as codifying the historic tax treatment of contributions in aid of construction of regulated public utilities.

Prior Congressional action

The provision relating to contributions in aid of construction for regulated public water and sewage utilities was added to the 1976 Act by the Senate Finance Committee. The Committee provision did not apply to gas and electric utilities. During the consideration of the 1976 Act on the Senate floor, an amendment was offered to include gas and electric utilities but the amendment was not adopted.

Departmental position

[The Treasury Department opposes the bill.]

7. H.R. 12200—Mr. Holland

Election to Treat Qualified Stock Options as Nonqualified Options

Present law

Qualified stock option

As a general rule, no income is recognized by a corporate employee when the employee receives or exercises a "qualified stock option" to receive stock in the employer corporation (secs. 421, 422).¹ The stock acquired on exercise of the option is a capital asset in the hands of the employee. Accordingly, if the employee holds the shares for at least three years (as required for the option to remain qualified), any excess of proceeds on sale of the stock over the price paid by the employee on exercising the option is treated as long-term capital gain.²

No deduction is available to the employer as a business expense (under sec. 162) with respect to either the granting of a qualified stock option or the transfer of stock to the employee on exercise of the option.

On exercise of a qualified stock option, any excess of the then fair market value of the stock over the price paid for the stock is treated as an item of tax preference. In addition, one-half of any long-term capital gain recognized upon sale of the stock received on exercising the option is treated as an item of tax preference. An item of tax preference is subject to the 15-percent "minimum tax" (sec. 56) and, in addition, reduces (dollar for dollar) the amount of personal service income entitled to the 50-percent "maximum tax" rate (sec. 1348).

Nonqualified stock options

Under present law, the transfer to a corporate employee of a nonqualified stock option without a "readily ascertainable fair market value" does not constitute income (Treas. Reg. § 1.421-6). When the nonqualified option is exercised, any excess of the fair market value of the stock over the option price generally is taxed to the employee as ordinary income (sec. 83). The income is not treated as an item of tax preference for purposes of the minimum tax; and the

¹ A qualified option (meeting the requirements of sec. 422) must be granted pursuant to a plan approved by the shareholders of the corporation. The option, by its terms, must be exercised within five years from the date it is granted, and the purchase price of the shares (option price) may not be less than the fair market value of the company's stock on the date when the option is granted to the employee. The option must also be exercised while the option holder is an employee of the corporation, or within three months after the termination of employment.

² If stock received pursuant to exercise of a qualified stock option is disposed of within three years from the date the option is exercised, the option does not remain qualified. In that case, the taxpayer recognizes income, and the employer obtains a deduction, in an amount equal to the difference between the fair market value of the stock at the time the option is exercised and the option price. If the disposition of the stock occurs during the same taxable year in which the option is exercised, the minimum tax provisions do not apply.

income generally qualifies for the 50-percent maximum tax rate on personal service income. The employer is allowed a deduction equal to the amount that the employee includes in income.

Effect of 1976 Act

Pursuant to the Tax Reform Act of 1976, the tax treatment of "qualified stock options" as summarized above applies only to options granted prior to May 21, 1976 (or, under transitional rules, to certain later-issued options). Options granted by a corporation after that date are treated as nonqualified stock options. In addition, any qualified option not exercised by May 21, 1981, does not continue to be qualified after that date.

The 1976 Act made other changes which affect the taxation of options which continue to be treated as "qualified stock options." First, the rate of the minimum tax was increased from 10 percent to 15 percent, and the annual exemption from the minimum tax was decreased from \$30,000 plus the full amount of regular tax liability to the higher of one-half of regular taxes paid or \$10,000. Second, the maximum tax provisions were amended to provide that the amount of personal service income subject to the 50-percent rate is reduced dollar for dollar by all tax preferences (with no exemption). Also, income recognized on exercise of nonqualified options was made eligible for the 50-percent maximum rate. In some situations, these changes to the minimum tax and maximum tax provisions have resulted in less favorable treatment on the exercise of a qualified stock option than if the option were not a qualified option.

The Tax Reform Act of 1976 was enacted on October 4, 1976, but the changes to the minimum tax for individuals were effective for taxable years beginning after December 31, 1975. As a result, taxpayers exercising qualified stock options in taxable years beginning after 1975 may be subject to a greater tax than taxpayers exercising generally similar but nonqualified options.

Issue

The issue is whether an individual taxpayer should be allowed to elect to treat a qualified option as a nonqualified option for taxable years beginning after December 31, 1975.

Explanation of the bill

The bill would allow an individual taxpayer to file an election to treat an otherwise qualified stock option as a nonqualified option (subject to section 83 of the Code). Thus, an electing taxpayer would recognize ordinary income, in the year the option is exercised, equal to the difference between the fair market value of the stock at the date of exercise of the option and the price paid for the stock, and the employer would receive a corresponding deduction. The election would be made at such time and in such manner as the Treasury Department prescribes by regulations.

Effective date

The bill would apply to taxable years ending after December 31, 1975.

Revenue effect

It is estimated that enactment of this provision would reduce budget receipts by \$5 million in fiscal year 1979 and by less than \$5 million each year thereafter.

Departmental position

The Treasury Department does not oppose the bill. However, the Treasury believes that, in order to prevent windfall benefits to employers, the bill should specifically provide that the employer's deduction, if any, is determined under the rules applicable to qualified stock options (sec. 422(c)(4)).

8. H.R. 12352—Mr. Rostenkowski

Source of Income of Railroad Rolling Stock

Present law

Under present law, the source of income or loss from the rental of personal property generally depends on whether the property is used inside or outside the United States. Where railroad rolling stock is leased to U.S. railroads and the railroad cars are used on a temporary basis in Canada or Mexico, the amount of the income or loss derived by the lessor of the rolling stock which is treated as from U.S. sources and the amount which is treated as from foreign sources is determined by prorating that income or loss in accordance with the amount of time the rolling stock is physically inside and outside the United States during the year.

Typically, under a lease financing of railroad rolling stock (the rolling stock is purchased by a financial institution and leased to the railroad), the lease produces a tax loss during its early years to the lessor (primarily as a result of accelerated depreciation or amortization deductions). Where the rolling stock is used in Canada or Mexico, the loss arising on the lease while the rolling stock is in those countries is considered to be a foreign source loss under the generally applicable source rules. The characterization of the loss as foreign source operates to reduce the lessor's foreign source taxable income and thus its foreign tax credit limitation. Under certain circumstances, this may cause the lessor to lose a foreign tax credit, to which it would otherwise be entitled, for foreign taxes paid with respect to its other foreign operations. As a result, this type of lease-financing transaction is less attractive than a lease-financing transaction involving equipment to be used exclusively in the United States.¹

Ships and aircraft are financed through similar long-term leases from financial institutions, and lessors expressed similar concern about the loss of foreign tax credits. Under the Revenue Act of 1971, lessors of certain ships and aircraft were given an election to treat all income and loss from the rental of the ships or aircraft as from sources within the United States (Code sec. 861(e)).

Issue

The issue is whether the source of income rules should be changed so that all income and loss from rental of railroad rolling stock which is used predominantly within, but temporarily outside, the United States would be treated as from U.S. sources.

¹ Because of these tax considerations, some financial institutions are understood to require that indemnity provisions be inserted in the leases under which the lessee railroads must bear the cost of any adverse tax consequences to the lessor which may result from the use of the leased equipment outside the United States. The potential liability under these indemnity provisions has been said to have deterred lessees from using the lease-financed rolling stock outside the United States and therefore to have resulted in inefficient utilization and routing of the rolling stock.

Explanation of the bill

The bill would modify the source rules applicable to income from the rental of railroad rolling stock. Under the bill, income or loss from the rental of railroad rolling stock to a U.S. railroad would be treated as from U.S. sources as long as the rolling stock is leased for use within the United States and the only expected use of the rolling stock outside the United States is in Canada or Mexico on a temporary basis (not expected to exceed a total of 90 days in any taxable year). No foreign tax credit would be allowed for any foreign taxes imposed on rental income treated as from U.S. sources under the bill. (It is understood that no foreign taxes are presently imposed on that income).

Effective date

The bill would be effective with respect to rolling stock placed in service after the date of enactment. However, with respect to rolling stock placed in service prior to the date of enactment, the new source rule would be elective for taxable years beginning after the date of enactment.

Revenue effect

It is estimated that enactment of this bill would reduce budget receipts by a negligible amount annually.

Departmental position

The Treasury Department opposes the bill.

9. H.R. 12592—Mr. Frenzel

Services Provided by a Private Foundation as Trustee

Present law

The Tax Reform Act of 1969 added a provision to the Internal Revenue Code (sec. 4941) which prohibits acts of "self-dealing" between private foundations and certain designated classes of persons (referred to as "disqualified persons") by imposing a graduated series of excise taxes on the self-dealer (and also on the foundation manager who willfully engages in acts of self-dealing). Under this provision, the furnishing of services by a private foundation to a disqualified person generally is classified as an act of self-dealing, even if the foundation receives reasonable compensation for the services it performs. However, the furnishing of services by a private foundation to a disqualified person is not an act of self-dealing if it is done on a basis no more favorable than that on which the services are made available to the general public and the services are functionally related to the exempt purpose of the foundation. In addition, the 1969 Act provided transitional rules permitting the continuation, without violation of self-dealing rules, of services which are shared between the private foundation and the disqualified persons until 1979, so long as the services were pursuant to an arrangement in effect on October 9, 1969, and that arrangement would not be a prohibited transaction under the law prior to the 1969 Act (sec. 101(l)(2)(D) of the Tax Reform Act of 1969). If disqualified persons hold more than 35 percent of the beneficial interest in a trust, the trust is also a disqualified person.

The Internal Revenue Service has taken the position that, where a foundation serves as trustee of a trust which is a disqualified person, the foundation is furnishing services to a disqualified person and, therefore, is engaged in an act of self-dealing. The Service takes this position even where the foundation is also a beneficiary of the trust.

In at least some instances, foundations are prohibited by local law from serving as trustee of any trust other than one in which they have a beneficial interest. In the Service's view, this restriction makes unavailable the exception for furnishing services on a basis no more favorable than that on which those services are made available to the general public.

Issue

The issue is whether a private foundation should, under limited circumstances, be permitted to serve as trustee of a trust which is a disqualified person where the private foundation is a beneficiary of the trust.

Explanation of the bill

The bill would provide an exception to the self-dealing rules under which the furnishing of services by a private foundation to a disqualified person would not be an act of self-dealing if (1) the services

are furnished in the capacity of trustee for an irrevocable trust established prior to October 9, 1969, designating the private foundation as trustee; (2) the foundation may not under the laws of the State of its incorporation act as trustee of a trust other than one in which it possesses a beneficial interest; (3) the private foundation receives compensation from the trust for the services performed as trustee which is reasonable in light of the facts and circumstances, whether or not the private foundation provides such services to the general public; and (4) the disqualified person attained that status solely because of the operation of a trust instrument which was irrevocable prior to October 9, 1969.

The intended beneficiaries of the bill are the Hormel Foundation, incorporated in Minnesota, and certain trusts of which it is trustee.

Effective date

The bill would apply to services furnished after the date of enactment.

Revenue effect

It is estimated that the bill would reduce budget receipts by less than \$1 million annually.

Departmental position

The Treasury Department opposes the bill on the following grounds. The Congress provided a ten-year transition period to enable organizations subject to certain of the self-dealing provisions to rearrange their affairs. There has been no showing that the Hormel Foundation or the trusts for which it provides services have taken any steps to avoid the application of section 4941 upon the expiration of the transition period. In the absence of such efforts, permanent legislative exemption from the self-dealing rules is inappropriate. Moreover, even if such efforts had been made, providing trustee services is not functionally related to the exempt purposes of the Hormel Foundation. There is nothing unique about trustee services which requires that they be performed by the Hormel Foundation.

10. H.R. 12606—Mr. Waggoner

Tax-Deferred Annuities for Employees of Uniformed Services University of the Health Sciences

Present law

If an annuity is purchased for an employee by an exempt organization described in section 501(c)(3) of the Code or by a public school system, the employer's contributions for the annuity contract are, within certain limitations, excludable from the employee's gross income and not subject to tax until the employee receives payments under the annuity contract (sec. 403(b)). Subject also to limitations generally applicable to tax-qualified retirement plans, the amount excludable in any year cannot exceed 20 percent of the employee's current annual compensation times the number of years of service, less amounts contributed tax-free in prior years.

In addition, an estate tax exclusion is provided for a retirement annuity contract which is receivable by a beneficiary (other than an executor) if it was purchased for a deceased employee by an employer which is a tax-exempt educational organization or a religious organization (sec. 2039(c)(3)). This exclusion does not generally apply to annuity contracts purchased by other organizations exempt from tax under section 501(c)(3).

In P.L. 92-426, Congress authorized establishment (under the Department of Defense) of the Uniformed Services University of the Health Sciences in order to train medical students for the uniformed services. This legislation authorizes hiring civilian faculty and staff members at salary schedules and with retirement benefits similar to those given to the faculty and staff of medical schools in the Washington, D.C. area. On July 15, 1975, the Secretary of Defense approved a tax-deferred annuity program for the faculty, similar to annuities available at medical schools in the Washington area and throughout the United States. However, because the University is a Federal instrumentality and is not an exempt organization described in section 501(c)(3), the Internal Revenue Service has ruled that the annuities do not qualify under present law for tax deferral pursuant to section 403(b).

Issue

The issue is whether annuities purchased for the civilian faculty and staff of the Uniformed Services University of the Health Sciences should qualify for income tax deferral in the same manner as annuities purchased for employees of exempt organizations described in section 501(c)(3) or of public school systems.

Explanation of the bill

The bill would treat otherwise qualified annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences in the same manner for income tax purposes (sec.

403(b)) as employee annuities purchased by section 501(c)(3) organizations or by public school systems.

The bill does not specifically extend the estate tax exclusion for retirement annuities purchased by exempt educational organizations to annuities purchased by the Uniformed Services University of the Health Sciences.

Effective date

This bill would apply to annuities purchased for service performed after December 31, 1977.

Revenue effect

The bill is estimated to result in a decrease in fiscal year budget receipts of less than \$1 million per year.

Departmental position

Although the Treasury Department does not believe that section 403(b) represents sound tax policy, it does not oppose the bill in the context of present law.

11. H.R. 12828—Mr. Jenkins

Convention and Trade Show Activities of Certain Tax-Exempt Organizations

Present law

Under present law, certain otherwise tax-exempt organizations are subject to Federal income taxation on unrelated business taxable income (secs. 511–514 of the Code). These organizations include charitable organizations described in section 501(c)(3), labor unions and similar organizations described in section 501(c)(5), and trade associations and similar organizations described in section 501(c)(6).

An organization's unrelated business taxable income is its gross income derived from regularly carrying on an unrelated trade or business, less certain allowable deductions. An unrelated trade or business is a trade or business the conduct of which is not substantially related to the performance by the organization of its exempt functions.

Section 1305 of the Tax Reform Act of 1976 amended section 513 of the Code to exempt from the unrelated business income tax any income derived from a qualified convention and trade show activity carried on by an organization which is exempt under section 501(c)(5) or (6) of the Code and which regularly conducts as one of its exempt purposes a convention or trade show activity which stimulates interest in, and demand for, the products of the industry in which the members of the organization generally are engaged. In order to constitute a qualified convention and trade show activity, all the following conditions must be met: (1) the activity must be conducted in conjunction with an international, national, State, regional, or local convention, annual meeting, or show; (2) one of the purposes of the organization in sponsoring that activity must be the promotion and stimulation of interest in, and demand for, the industry's products and services in general; and (3) the show must promote that purpose through the character of the exhibits and the extent of the industry products displayed.

Issues

The first issue is whether to treat a convention or trade show activity as a qualified activity (so that the income derived therefrom is not subject to tax) if one of the purposes of the organization in sponsoring the activity is the education of persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry. The second issue is whether the tax treatment of income from qualified convention and trade show activities should be extended to apply to organizations described in section 501(c)(3) of the Code.

Explanation of the bill

The bill would exempt from the unrelated business income tax any income derived from an otherwise qualified convention and trade show activity (including the leasing of exhibition space to suppliers

who make sales to the organization's members) if one purpose of the organization in sponsoring the activity is the education of persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry. Thus, the present-law exemption, which applies to income derived from certain activities promoting the products and services of the industry in which the organization's members are engaged, would be extended to income derived in connection with so-called "supplier shows" intended to educate the sponsoring organization's members in the development of new products and services, or new rules and regulations, affecting the industry in which the members are engaged.

The bill also would extend the exemption for income from qualified convention and trade show activities to such activities conducted by organizations described in section 501(c)(3) of the Code.

Effective date

The bill would apply to qualified convention and trade show activities carried on in taxable years beginning after October 4, 1976.

Revenue effect

It is estimated that adoption of this provision would decrease budget receipts by less than \$1 million annually beginning with fiscal year 1979.

Departmental position

The Treasury Department opposes this bill on the following grounds. Current law does not in any way prevent organizations described in section 501(c)(5) or section 501(c)(6) from conducting so-called "suppliers' shows". Also, current law does not prevent organizations described in section 501(c)(3) from leasing space to suppliers of goods and services to the members of the organization in connection with the organizations' annual convention or meeting. All current law does is to provide that, if in such instances exhibitors are permitted to take orders or make sales, income from the lease of exhibition space will be taxed.

Current law provides for a different result in the case of certain organizations described in section 501(c)(5) or section 501(c)(6). For such organizations, income from leasing space to exhibitors is exempt even though the exhibitors are permitted to carry on sales activity. This is only so, however, where one of the exempt purposes of the organizations and one of the organization's purposes in carrying on the show in question, is to stimulate interest and demand for the *products of the organization's members*. Not taxing such income is arguably consistent with the principal purpose for which a business league or trade association is granted an exemption from tax, namely "to promote" the "common business interest" of the association members, and "not to engage in a regular business of a kind ordinarily carried on for profit." Section 1.501(c)(6)-1 of the Income Tax Regulations.

This rationale is not present in the case of so-called suppliers' shows carried on either by organizations described in section 501(c)(5) or 501(c)(6) or by organizations described in section 501(c)(3). To take a typical example, the proposed legislation would exempt income derived by a professional organization of physicians, which, in con-

nection with its annual meeting, leased space to manufacturers of medical equipment and pharmaceuticals where the exhibitors were permitted to take orders and make sales. Such sales activity is not substantially related to the exempt purpose of the physicians' association, but rather permits the organization to derive income from operation of a convenient shopping forum for its members. Such income properly should be taxed.



